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No. 68

In the Supreme Court of the United States

OCTOBER TERM, 1929

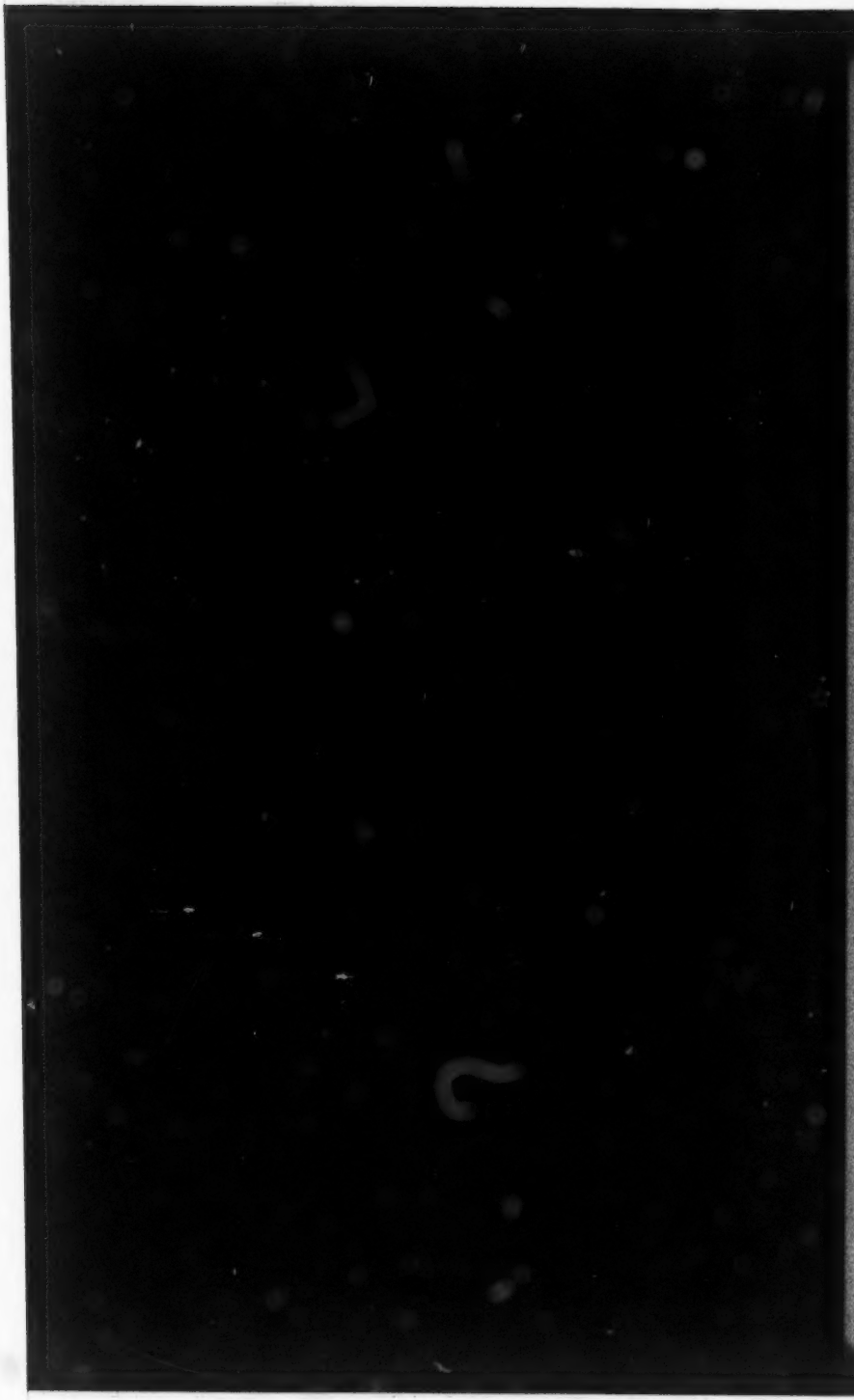
JESSE W. CLARKE, COLLECTOR OF INTERNAL REVENUE FOR THE TWENTY-FIRST DISTRICT OF NEW YORK, PETITIONER

v.

THE HABERLE CRYSTAL SPRINGS BREWING COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER



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v.

THE HABERLE CRYSTAL SPRINGS BREWING COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The referee's opinion is found on page 224 of the Record. The opinion of the United States District Court for the Northern District of New York (R. 234) is reported in 20 F. (2d) 540. The opinion of the Circuit Court of Appeals (R. 303) is reported in 30 F. (2d) 219.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on January 21, 1929. (R. 309.) Peti-

tion for certiorari was filed April 19, 1929. Certiorari was granted May 13, 1929. (R. 310.) Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Does Section 234 (a) (7) of the Revenue Act of 1918 permit a taxpayer to deduct from its gross income any portion of the March 1, 1913, value of the good will of the business prior to the time that the value of that good will was destroyed by Federal legislation which proscribed the kind of business in which the taxpayer was engaged?

STATUTE INVOLVED

The pertinent provisions of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077, 1078, are as follows:

> SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * * * *
>
> (7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;
>
> * * * * *

STATEMENT

The Haberle Crystal Springs Brewing Company, the taxpayer and respondent herein, was a New York corporation organized in 1892. It was en-

gaged in the manufacture of lager beer and ale from the date of its incorporation until October 29, 1919, when it was compelled to cease such business by reason of Federal prohibition legislation, which was temporary in character. At all times material to the determination of this case it kept its accounts and records on the basis of a fiscal year ending May 31st. (R. 202.)

The National Prohibition Amendment was ratified by the requisite number of States on January 16, 1919 (R. 213), and became effective on January 16, 1920 (R. 206). By January 31, 1918, it became reasonably apparent that national prohibition would be adopted. (R. 206.) After national prohibition became effective by Federal legislation, the respondent had no good will and the value of its good will was wholly destroyed by prohibition legislation. (R. 207.) After October, 1919, the respondent confined its brewing activities to one of its two plants, where it continued in the business of manufacturing and selling soft drinks and cereal beverages until its liquidation on December 23, 1920. During this period its operations were conducted at a loss. (R. 207.) It sold such products during this period under the name of "Congress," which it had previously used as a trade name for its beer. The trade name applicable to its ale, to wit, "Derby Cream," was not used. (R. 209.)

The method of liquidation of the respondent consisted in a transfer of the greater part of its assets

to two newly formed corporations the stockholders of which, with the exception of one individual, were identical with the stockholders of the respondent. (R. 208.)

This action was instituted by the taxpayer in the United States District Court for the Northern District of New York and was referred to a referee (R. 22), who made findings of fact (R. 202) which were not changed by the District Court (R. 236). His conclusions of law (R. 213) in favor of the plaintiff were, however, not confirmed (R. 235). The court entered judgment for the defendant. (R. 219.) From this judgment appeal was taken to the United States Circuit Court of Appeals for the Second Circuit (R. 198), which reversed the judgment of the District Court (R. 309).

The respondent contends that under the provisions of Section 234 (a) (7) of the Revenue Act of 1918 it was entitled to deduct from the income of its fiscal year ending May 31, 1919, for obsolescence of its good will, which was wholly destroyed by the adoption of the Prohibition Amendment, 365/715 of the March 1, 1913, value thereof. The numerator of this fraction is the number of days in the fiscal year 1919; the denominator is the number of days from January 31, 1918, when it became reasonably apparent that national prohibition would be adopted, to January 16, 1920, when the Prohibition Amendment became effective. The petitioner contends that the statute does not authorize such a deduction.

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that the respondent was entitled under Section 234 (a) (7) of the Revenue Act of 1918 to a deduction from its gross income for the fiscal year ending May 31, 1919, on account of the exhaustion, wear and tear, or obsolescense of its good will, since the statute only intended to embrace property of such a nature that it was decreased, consumed, or disposed of by use in the trade or business, and good will is not such property.

SUMMARY OF ARGUMENT

In enacting the various excise or revenue Acts from 1909 until the Revenue Act of 1918, Congress provided for deductions from income for depreciation only in respect to those assets which were consumed or used up in the taxpayer's trade or business. The regulations and rulings of the Bureau of Internal Revenue construed these Acts in accordance with the legislative intent as above stated. An apparent exception was made as to patents and copyrights which may be explained on the theory they are prepaid business expenses. While an allowance had been permitted by the Treasury under the loss section of the statute for obsolescence of property in the year in which it became obsolete, such a deduction is clearly distinguishable from an allowance for true "obsolescence."

In enacting the Revenue Act of 1918, Congress did not intend to change the nature of the deprecia-

tion deduction, but meant to confine it to wasting assets. The change in wording of this Act was made for the purpose of allowing a supplemental deduction for obsolescence of wasting assets in those cases where the normal allowance for exhaustion, wear and tear would be insufficient to return the cost of such assets for the period of their useful life. By including a reasonable allowance for obsolescence in that for exhaustion, wear and tear Congress did not intend to provide a new and independent deduction nor to add any new species of property to that previously subject to the depreciation allowances. The word "including" only enlarges the previous allowances by introducing the specific element constituting the enlargement, namely, obsolescence. This appears from a consideration of the grammatical construction of the language and the meaning of the terms used. Such regulations and decisions as proceed upon the theory that intangible property suffers an actual loss of value by reason of the efflux of time serve to throw no light on the legislative intent in respect to the 1918 Act, since they were rendered after its enactment. Except in so far as they allow deduction for depreciation of an interest in wasting assets, they are incorrect in principle.

Good will exists only as an incident to a going business and is not an asset which can be exhausted or consumed by use. The fact that in a particular case its life may be limited because the duration of

the business of which it is a part is limited does not make it property subject to the allowance provided in Section 234 (a) (7). Even assuming that good will is property used in a trade or business within the meaning of the term, it was not the legislative intent to allow any recoupment of its March 1, 1913, value by a deduction for exhaustion, wear and tear, or obsolescence.

ARGUMENT

THE STATUTORY ALLOWANCE FOR OBSOLESCENCE IN THE REVENUE ACT OF 1918 WAS INTENDED TO BE APPLIED ONLY TO PROPERTY WHICH IS SUBJECT TO EXHAUSTION, WEAR AND TEAR. GOOD WILL IS NOT PROPERTY OF THAT CHARACTER AND HENCE NO DEDUCTION FOR OBSOLESCENCE IS PERMITTED

On the question here involved there is a conflict of opinion. The Circuit Court of Appeals for the Second Circuit has held in the instant case that obsolescence of good will is within the scope of the allowance for obsolescence in the Revenue Act of 1918.

On the other hand, the Circuit Court of Appeals for the Eighth Circuit in *Red Wing Malting Co.* v. *Willcuts,* 15 F. (2d) 626, certiorari denied 273 U. S. 763; the Circuit Court of Appeals for the Ninth Circuit in *Landsberger* v. *McLaughlin,* 26 F. (2d) 77; and the Circuit Court of Appeals for the Third Circuit in *Renziehausen* v. *Commissioner,* 31 F. (2d) 675, now pending in this Court on writ of certiorari, No. 114, October Term, 1929, have held that under the Revenue Act of 1918 no deduction is al-

lowed for the obsolescence of good will for the reason that the allowance for obsolescence in the statute is supplementary to the allowance for exhaustion, wear and tear, and is limited to property which is subject to depreciation by exhaustion, wear and tear, and therefore excludes such intangible property as good will.

The same view of obsolescence was adopted by the Board of Tax Appeals. *Joseph Garneau Co., Inc.*, v. *Commissioner*, 8 B. T. A. 1041; *Fred Eberlin Co.* v. *Commissioner*, 8 B. T. A. 1107; *Appeal of Manhattan Brewing Co.*, 6 B. T. A. 952.

We contend that the decision of the court below is erroneous and that the *Red Wing* and other cases cited above represent the better view. The Circuit Court of Appeals for the Third Circuit in the *Renziehausen case* had the benefit of the contrary opinion of the court below herein but declined to adopt it, holding that the statutory deduction did not apply to property of the character of good will.

The views of the Government can not be better expressed than in the following language from the exhaustive opinion of the Circuit Court of Appeals for the Eighth Circuit in the *Red Wing case* (15 F. (2d) pp. 630–633):

> With these general propositions in mind, we proceed to a discussion of the statute in question. No difficulty arises as to the first part of subsection (7) of section 234 (a), "a reasonable allowance for the exhaustion, wear

and tear of property used in the trade or business." That is clear enough as defining the deduction. The controversy is over the part of the subsection following these words, viz, "including a reasonable allowance for obsolescence." Does this provide for a new, distinct deduction, or is it so attached and related to the previous phrase in subdivision (7) that it applies only to such property used in the business as is subject to exhaustion, wear, and tear?

* * * * *

If it had been intended by the Congress to create a new and additional deduction not connected with property used in the business subject to "exhaustion, wear and tear," it would have been very easy for Congress, instead of using the word "including," to have said, "a reasonable allowance for exhaustion, wear and tear and obsolescence of property used in the business." That would have made the matter clear.

The first part of the subsection provides for a deduction in arriving at tax income for the depreciation by exhaustion, wear, and tear of property used in the business. Depreciation was the matter sought to be remedied in order to restore to the owner the basis of original value. It is perfectly apparent that an allowance for depreciation due to exhaustion, wear, and tear of property might not sufficiently provide for the restoration of capital over the period of useful life of an asset, and it might be entirely inadequate to effect restoration of the March

1, 1913, value thereof. The meaning of the word "including," as used in the statute, is important. It evidently refers to the preceding part of the subsection, and must be recognized as occupying a significant and important place. It cannot be brushed aside and ignored. This court should not attempt to write new language into the statute, nor ignore language there used, but must endeavor, from the language of the statute itself, to arrive at the meaning of the Congress. This word has received considerable discussion in opinions of the courts. It has been productive of much controversy.

* * * * *

Perhaps the most lucid statement the books afford on the subject is in *Blanck et al.* v. *Pioneer Mining Co. et al.*, 93 Wash. 26, 30, 159 P. 1077, 1079, namely: "The word 'including' is a term of enlargement and not a term of limitation, and necessarily implies that something is intended to be embraced in the permitted deductions beyond the general language which precedes it. But, granting that the word 'including' is a term of enlargement, it is clear that it only performs that office by introducing the specific elements constituting the enlargement. It thus, and thus only, enlarges the otherwise more limited preceding general language. * * * The word 'including' introduces an enlarging definition of the preceding general words, 'actual cost of the labor,' thus of necessity excluding the idea of a further enlargement than that furnished by the enlarging clause

so introduced. When read in its immediate context, as on all authority it must be read, the word 'including' is obviously used in the sense of its synonyms 'comprising; comprehending; embracing.' "

It seems to us that the language "including a reasonable allowance for obsolescence" is but a part of and an enlargement of the previous phrase of the said subsection (7) relating to exhaustion, wear, and tear, and that the first part of the sentence was intended to cover the subject-matter thereof. It does not add a new kind of deduction, but merely permits the inclusion of an additional element, namely, obsolescence of such property used in the business as is subject to exhaustion, wear, and tear. The allowance for obsolescence was intended to be in connection with the allowance for exhaustion, wear, and tear; that being at times insufficient to restore the proper basis of capital values.

The history leading up to the enactment of subsection (7) of section 234 (a) of the 1918 act is important. The Excise Tax Act of 1909 (36 Stat. 112) § 38, permitted deduction of "a reasonable allowance for depreciation of property, if any." Regulations of the Treasury Department provided that the deduction should be the loss "that arises from exhaustion, wear and tear, or obsolescence out of the uses to which the property is put." The United States District Court for the Northern District of California, in *San Francisco & P. S. S. Co.* v. *Scott, Collector,* 253 F. 854, 855, discussed depreciation

as used in that statute, and said: "It is intended to cover the estimated lessening in value of the original property, if any, due to wear and tear, decay, or gradual decline from natural causes, inadequacy, obsolescence, etc., which at some time in the future will require the abandonment or replacement of the property, in spite of ordinary current repairs."

The Revenue Act of 1913 (38 Stat. 172) had this provision: "A reasonable allowance for depreciation by use, wear and tear of property, if any." The regulations under this act recognized the interpretation put upon the word "depreciation" under the previous act, and made an allowance for obsolescence "out of the uses to which the property is put."

The 1916 act (Comp. St. § 6336f) dropped the word "depreciation," and the deduction permitted was "a reasonable allowance for the exhaustion, wear and tear of property within the United States arising out of its use or employment in the business or trade." After that there was no basis for a deduction for obsolescence, as the depreciation deduction under the 1916 act excluded obsolescence.

When the Revenue Act of 1918 was before the Congress, the House wrote a provision the same as in the 1916 and 1917 acts, providing an allowance for "exhaustion, wear and tear" of property. The Senate adopted an amendment substituting the word "depreciation" for "exhaustion, wear and tear."

In conference, the word "depreciation" was stricken out, the words "exhaustion, wear and tear," restored, and the words "including a reasonable allowance for obsolescence" included. In this form the bill passed.

It would seem quite apparent, therefore, that Congress was not intending to add a new and independent deduction. It was merely trying to provide the restoration of capital value of a depreciable asset over the period of its useful life by allowing something, known as obsolescence, as an additional element to exhaustion, wear, and tear. This legislative history sustains, we think, the conclusion to which we are forced that the phrase "including a reasonable allowance for obsolescence" is one of specification and enlargement; that it is closely connected with and relates to the subject-matter of the other phrase of said subsection (7), and applies only to such property therein designated used in the business as is subject to exhaustion, wear, and tear.

That leads to the query, is good will such property? Good will is property of an intangible nature. It differs from such intangibles as patents, copyrights, licenses, and franchises, because, while in a certain sense it inheres in and is used in the business, it is not subject to depreciation, as that term is commonly understood and commonly used in the statutes. The Supreme Court of the United States in *Metropolitan Bank* v. *St. Louis Dispatch Co.*, 149 U. S. 436, 446, 13 S. Ct. 944, 947 (37 L. Ed. 799) says:

"Undoubtedly, good will is in many cases a valuable thing, although there is difficulty in deciding accurately what is included under the term. It is tangible only as an incident, as connected with a going concern or business having locality or name, and is not susceptible of being disposed of independently. Mr. Justice Story defined good will to be 'the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessity, or even from ancient partialities or prejudices.' Story, Part. § 99."

* * * * *

We are satisfied there can be no wear or tear of good will, or exhaustion thereof by use, and, even should we assume that good will, separate and distinct from tangible property, is property used in the business, section 234 (a), subsection (7), of the 1918 Revenue Act limits the allowance for obsolescence to such property as is susceptible to exhaustion, wear, and tear by use in the business, and good will is not such property.

The question involved is solely one of statutory construction. In deciding such a question arguments addressed to the economic wrong involved

in the imposition of a tax are beyond judicial cognizance. *Brushaber* v. *Union Pac. R. R.*, 240 U. S. 1. This principle applies though the court may perceive hardship in taxing receipts as income without providing deductions on account of the exhaustion of the property. *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, 525. Congress has adopted its own criteria that look to certain rather severe tests of liability and exemption. *Weiss* v. *Weiner*, 279 U. S. 333, 337.

Moreover, respondent is claiming a deduction. This is not a matter of inherent right, because, where the income does not result from a sale or conversion of capital assets, Congress has power to require the payment of taxes without allowing any deduction for the purpose of returning to a taxpayer his entire invested capital at the expiration of the life of the property from which the income was derived. *Kentucky Tobacco Products Co.* v. *Lucas*, 5 F. (2d) 723, 728. If respondent has any right to the deduction which is claimed in this case that right must be found in the words of the statute.

Congress made the first definite provision for obsolescence in the Revenue Act of 1918. Since the allowance for obsolescence is an outgrowth of allowances previously made, a consideration of the practice under the prior Acts should throw some light upon the question. An examination of the prior Acts indicates that it was the intention of Congress to allow only deductions for capital assets which

were consumed or wasted by use in the taxpayer's business.

The Act of August 5, 1909, c. 6, 36 Stat. 11, 113, permitted a deduction for "all losses actually sustained within the year * * * not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any," which this Court, applying the rule of strict construction, held in *Von Baumbach* v. *Sargent Land Co., supra,* did not include the depletion of mines.

Under the Act of 1909 the Treasury did not permit any deduction for depreciation of good will. Paragraph 73, T. D. 1675, promulgated February 14, 1911.

The Act of October 3, 1913, c. 16, 38 Stat. 114, 172, paragraph G (b) (second), permitted a deduction for "depreciation by use, wear and tear of property" and the Treasury Regulations promulgated thereunder ruled that depreciation was not allowed in connection with good will. Article 136, Regulations 33.

The Revenue Act of 1916, c. 463, 39 Stat. 756, 768, Section 12 (a) Second, provided for "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade." The Treasury Regulations held that good will was an intangible asset of such nature that it was not subject to wear and tear and that no claim for depreciation in connection therewith would be allowed. Articles 167 and 168, Regulations 33, revised. Obsolescence of physical prop-

erty was recognized as a loss in the year in which the property became obsolete. Article 178, Regulations 33, revised. A deduction for the return of capital invested in patents was provided for, based upon actual cost. Article 174, Regulations 33, revised.

It thus appears that the statutes up to and including the Revenue Act of 1916 only permitted the deduction for depreciation or exhaustion, wear and tear in the case of those capital assets which were consumed or wasted in the production of income, and that they were so construed by the regulations. (Reg. 31, Art. 4, T. D. 1571; Reg. 33, Arts. 129, 130; Reg. 33, rev., Arts. 159, 160.) The appropriate method of measuring the deduction was taken to be an annual allowance based upon the estimated life of the asset in the business.

There is no inconsistency in the fact that the regulations permitted, under the head of depreciation, a return of the *cost* of patents by spreading it over the life of the patent. See Articles 137, 138, Regulations 33; Article 174, Regulations 33, revised. They may be explained on the theory that the amount invested in a patent was a prepaid cost of doing business and therefore should be spread over the term during which the property was used. The treatment was similar to that accorded to one who prepaid his insurance or his rent. It is obvious that such prepaid costs theoretically, at least, should not be charged against the income for the first year. But this is far different

from saying that the property itself is the subject matter of exhaustion, wear and tear. Even if it could be said that patents are of such a character that they are gradually exhausted during the limited life which they have, it is still true that they are unlike good will in that respect. Instead of being depreciated by use in the business, good will is of such a nature that in the ordinary business it grows through use and is actually enhanced in value. Accordingly, we submit that in any aspect there is sufficient distinction between patents and good will to justify different treatment.

At any rate, the Treasury consistently ruled that there was a difference between patents and good will and this is entitled to serious consideration in determining the legislative intent in the enactment of the Revenue Act of 1918. *United States* v. *Hermanos y Compañia,* 209 U. S. 337.

The Revenue Act of 1918 provided in Section 234 (a) (7) for the deduction of "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence."

Thus for the first time Congress provided a specific allowance for true obsolescence. While an allowance had been permitted by the Treasury under the loss section of the statute for "obsolescence" of property in the year in which it became obsolete, such a deduction is clearly distinguishable from an allowance for true "obsolescence."

Under this Act obsolescence becomes not a matter to be compensated for in the year in which the property becomes obsolete, as was the rule under the 1916 Act, but one to be added to the depreciation allowance. Since obsolescence never arises out of the use of property, the change in the phraseology of the 1916 Act was consistent with the introduction of obsolescence as a factor. But the controlling phrase "exhaustion, wear and tear of property" was not changed. The question then is whether this change of phraseology shows an intent on the part of Congress to add an entirely new species of property to that previously held to be the proper subject-matter of allowances under these sections.

It is submitted that the legislative history of Section 234 (a) (7) of the 1918 Act shows no such intent. This history is outlined in the opinion in *Red Wing Malting Co.* v. *Willcutts,* 15 F. (2d) at p. 632; *supra,* p. 12.

The structure of the statute itself indicates that Congress never intended the allowance to be applicable to intangible property, because the allowance was supplementary to that provided for in the prior Revenue Acts and was confined to property subject to exhaustion, wear and tear.

The words "exhaustion, wear and tear" in themselves connote only a physical consumption, lessening, or diminution of property. Clearly, this is so with respect to wear and tear. The word "exhaust" is defined in Webster's New International

Dictionary as "to draw forth; * * * to draw or let out wholly; * * * to empty by drawing or letting out the contents; * * * to use or expend wholly or till the supply comes to an end; to deprive wholly of strength; to use up * * *."

It is submitted that the allowance provided by the Act was intended to be in connection with the allowance for exhaustion, wear and tear, and that, by including obsolescence in the deduction, Congress enlarged it only to the extent of introducing the specific element constituting the enlargement, namely, obsolescence.

The word "include" is defined in the New Standard Dictionary as follows:

> (1) To comprise, comprehend, or to embrace as a component part, item, or member; as, this volume includes all his works; the bill includes his last purchase;
>
> (2) To enclose within; contain; confine; as, an oyster shell sometimes includes a pearl.

The arrangement of the sentence in Section 234 (a) (7) of the Act is significant. The phrase "including a reasonable allowance for obsolescence" immediately follows the provision for a "reasonable allowance for exhaustion, wear and tear of property used in the trade or business." The phrase is but a part of and an enlargement of the deduction for exhaustion, wear and tear, and the first part of the sentence was, we submit, intended to limit the subject-matter to which the phrase com-

mencing with the participle "including" should apply. The structure of the sentence indicates that it was not the intent to embrace any new kind of property but only to permit the inclusion of an additional element, to wit: "obsolescence," with respect to property to which the deduction for "exhaustion, wear and tear" would apply.

Upon a consideration of the definitions given in the dictionaries and decided cases, the Circuit Court of Appeals for the Eighth Circuit so held in the *Red Wing case* on page 631.

If Congress intended the allowance for obsolescence to apply to property not subject to exhaustion, wear and tear, it presumably would have used the following language: "a reasonable allowance for exhaustion, wear and tear, and obsolescence of property used in the trade or business." The word "and" would have had an "additive power" which the word "including" lacks. *Cf. Montello Salt Co.* v. *Utah,* 221 U. S. 452, 466.

In support of a contrary view the Circuit Court of Appeals pointed out that certain forms of intangible property such as patents and copyrights, licenses and franchises, are admittedly subjects of exhaustion or obsolescence allowances. It is our contention, as above stated, that the theory underlying these allowances was that such intangible assets had been acquired through a capital outlay, the cost of which should be returned by spreading it over the life of the asset. The cost of acquiring such assets

is a business expense which should have been permitted under Section 214 (a) (1) of the Revenue Act of 1918, rather than as depreciation and we submit that it was erroneous to treat the allowance as for the depreciation of the property itself.

The Circuit Court of Appeals cited cases showing that the statute permits the deduction of a reasonable allowance for the exhaustion of rights under patents, leases, and contracts of limited duration as follows: As to patents, *Van Kannel Revolving Door Co.* v. *Commissioner,* 11 B. T. A. 1209; *Perfect Window Regulator Co.* v. *United States,* 66 C. Cls. 147. As to leases, *Lynch* v. *Alworth-Stephens Co.,* 267 U. S. 364; *Philip Henrici Co.* v. *Reinecke* (N. D. Ill.), 3 F. (2d) 34; *Kaufman-Straus Co.* v. *Lucas* (C. C. A., 6th), 12 F. (2d) 774; *Appeal of Grosvenor Atterbury,* 1 B. T. A. 169; *Appeal of Secor Hotel Co.,* 7 B. T. A. 158; *Hawaiian Sugar Co.* v. *Commissioner,* 13 B. T. A. 683. As to contracts, *International Curtis Marine Turbine Co.* v. *United States,* 63 C. Cls. 597; *Kentucky Tobacco Products Co.* v. *Lucas* (W. D. Ky.), 5 F. (2d) 723; *Lassen Lumber & Box Co.* v. *Blair* (C. C. A., 9th), 27 F. (2d) 17; *Appeal of Atlantic Carton Corp.,* 2 B. T. A. 380.

The Treasury, of course, followed its regulations in its litigation so that generally the cases cited do not decide that such an allowance is proper, but, that being conceded, decide the proper amount to be allowed. Accordingly, such cases do not establish any principle.

In *Lynch* v. *Alworth-Stephens Co., supra,* this Court permitted a lessee of mining property a deduction for the depletion of the mine in proportion to his interest in the physical property being exhausted. We submit that case did not decide, as the court below seemed to think, that the statute permitted an allowance for the exhaustion of an intangible. It was held that the leases created a very real and substantial interest in the ore and that the lessee's right to the deduction was limited to the amount of exhaustion caused by the depletion of the mine. *Cf. Weiss* v. *Weiner,* 279 U. S. 333, 336.

Some of the cases cited do decide that certain intangible property is subject to depreciation. Thus in *Philip Henrici Co.* v. *Reinecke, supra,* the District Court for the Northern District of Illinois held that a lease acquired prior to March 1, 1913, and having on that date a bonus value was depreciable property. Subsequently, the Circuit Court of Appeals for the Sixth Circuit made the same holding in the case of *Kaufman-Straus Co.* v. *Lucas, supra,* and the District Court for the Western District of Kentucky made a similar holding in respect to a contract in the case of *Kentucky Tobacco Products Co.* v. *Lucas, supra.* In a case involving a lease the Board of Tax Appeals held that the allowance for exhaustion was applicable. *Appeal of Grosvenor Atterbury, supra.* These cases can only be explained on the theory that intangible property loses value by reason of the efflux of time. Assuming that in these cases there was any loss of value, it

was in no way related to the use of the property and we therefore submit that the decisions in those cases were erroneous. In such cases the property is existent as completely on the last day as on the first. It has not been worn or torn. It has not been exhausted, for nothing has been drawn from it. There is in fact no exhaustion, wear or tear, no loss of content. One who has a limited right similar to a contract or leasehold does not suffer a loss of such property by receiving all that to which it entitled him. Such a right is clearly not exhausted by the use to which it is applied.

These cases in so far as they recognize depreciation of intangibles, seem to overlook the clear meaning of the language used by Congress. The words exhaustion, wear and tear connote a subject-matter from which something can be taken. One exhausts a mine by removing the ore from it, but does not thereby exhaust the ownership. Ordinarily intangible property by its nature has no content which can be exhausted. A right is enforced or realized, not exhausted.

We submit that just as a deduction for depletion of mines was denied in *Von Baumbach* v. *Sargent Land Co., supra,* because it was held that the allowance for "depreciation" in the 1909 Act was not intended to include depletion, so a deduction for obsolescence of good will should not be permitted here because not within the legislative intent.

Depreciation is a cost of operation. Since a portion of the service life of equipment goes into each unit produced, depreciation constitutes a charge upon the business as much as the raw material out of which its finished product is made and the labor that fashions and forms it.

A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, as contemplated by the statute, regardless of whether it is referred to as depreciation or as something else, is that amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the useful life of the property in the business will suffice with the salvage value at the end of such useful life to provide in place of the property itself its cost or its value as of March 1, 1913. Article 161, Regulations 45. *United States* v. *Ludey*, 274 U. S. 295.

It thus being the purpose of the statute to allow a restoration of capital over the period of its useful life, it is apparent that in certain cases the allowance for depreciation would be inadequate to effect such restoration of the cost or the March 1, 1913, value of an asset. The useful life of an asset may be cut short by the development of the industry whereby production becomes more economical through the employment of new inventions or replacement is required to satisfy new ideas or changing fancies of the consumer. The progress of the art and the demand of the public for better service

have resulted in the displacement of old and antiquated equipment before it is worn out. No industry has escaped the seemingly inevitable trend toward the adoption of more modern and economical equipment which requires the scrapping of the old equipment, because, although still in good physical condition, it is inadequate. Obsolescence is the term used to describe this process of gradual falling into disuse. It is obvious that an annual allowance for exhaustion, wear and tear would be wholly inadequate to restore to the owner of such an obsolete asset its original cost. To meet this situation Congress supplemented the allowance for "exhaustion, wear and tear of property used in the trade or business" by "including a reasonable allowance for obsolescence."

While obsolescence can certainly be anticipated, its precise measurement is involved in some difficulty. However, it is often possible for qualified experts to foretell with reasonable certainty which units of equipment may be able to serve their entire physical life and what classes are so uneconomical or otherwise defective that some improvement may be expected. Obsolescence presupposes that at a reasonably definite future date, which can be foreseen with reasonable certainty, a particular asset will finally arrive at a state of becoming useless, such uselessness not being due to exhaustion, wear or tear through use, but to the fact that economic developments render it imperative that it be dis-

carded. (See the discussion of obsolescence in *Lassen Lumber & Box Co.* v. *Blair* (C. C. A., 9th), 27 F. (2d) 17; see also Article 166 of Regulations 65, construing the identical provision of the Revenue Act of 1924.)

Ordinarily such a theory has no application to good will. The respondent's good will was not an interest which became exhausted by use. The interest is unique; it exists only as an incident to a going concern or business having locality or name and is not susceptible of being disposed of independently. *Metropolitan Bank* v. *St. Louis Dispatch Co.*, 149 U. S. 436, 446. A fitting description of it is found in Parsons on Partnership (4th ed.), Section 181, where it is said that—

> the only proper signification of the word must be, that benefit or advantage which rests only on the *good-will*, or kind and friendly feeling of others * * *. * * * It is a hope or expectation, which may be reasonable and strong, and may rest upon a state of things that has grown up through a long period, and been prompted by large expenditures of money. And it may be worth all the money it has cost, and a great deal more; but it is, after all, nothing more than a hope, grounded upon a probability.

Good will is not affected by the multitude of factors which contribute to the obsolescence of physical assets. It has no approximate period of useful life, and the exercise of the police power is probably the

sole instance where a reasonably definite future date can be foreseen when good will will be without value. Since good will is based and must be valued on the ability to make above normal profits, its value rises and falls with the profits of the business, and it is unreasonable to suppose that Congress in providing a rule of general application intended that the decrease in value of a changing thing like good will should operate to reduce gross income. Good will does not ordinarily depreciate, but only fluctuates in value, and it is not practicable to take these changing values into account for tax purposes.

We think it is clear that the word "obsolescence" does not aptly describe what happened to the good will in this case. It should be noted that reduction in value of its good will as a realized loss in the price obtained from the sale of petitioner's plant is not the matter here involved. Such a loss is provided for under Section 202 in the year in which it actually occurs. The deduction here is claimed on account of alleged obsolescence of property while ownership was retained by the taxpayer.

In view of the foregoing, we think it is evident that good will is of such a character that Congress in dealing with deductions for obsolescence and providing a rule of general application never contemplated that good will was susceptible of that sort of depreciation.

The Treasury Regulations issued under the 1918 Act construed the new allowance for obsoles-

cence as applying only to the same species of property to which the old allowance for depreciation applied and accordingly held that the allowance did not apply to good will. (Art. 163, Regulations 45.) The statutory provision was put into effect by permitting a revised estimate of the useful life of assets so as to allow for such future obsolescence as could be expected from experience to result from the normal progress of the art. (Art. 166, Regulations 45 (1920 ed.).)

The Revenue Acts subsequent to the Act of 1918 have continued the deduction for obsolescence without change in the language.

After the publication of the original regulations under the 1918 Act, in which good will was specifically excluded from the obsolescence allowance, there occurred a change in the attitude of the Treasury Department. Following a decision of the Advisory Tax Board, known as T. B. R. 44, published in 1 C. B. 133, holding that intangibles such as good will, trade-marks, or trade brands were the subject of an obsolescence allowance, the regulations were amended by deleting the language which specifically excluded such an allowance. (T. D. 2929.) Thereafter the Treasury Department recognized deductions for obsolescence of good will under various limitations and restrictions. (O. D. 472, 2 C. B., January–June, 1920, p. 141.) For example, good will was not recognized as separable from a going concern, and hence the deduction was not permitted in those cases where the taxpayer would

be able to continue in any similar business. (O. D. 472, *supra.*) It should be noted that the respondent continued in the similar business of manufacture and sale of soft drinks and cereal beverages after October, 1919, and sold such products under the name previously used as a trade name for its beer. (R. 209.) The amended regulations remained in effect for a period of nearly eight years and were again modified by T. D. 4055, restoring the provision that no deduction for depreciation, including obsolescence, is allowable in respect of good will. This has since been the rule and there have been no more deductions for obsolescence of good will.

The ruling permitting the deduction for obsolescence of good will occurred after the enactment of the Revenue Act of 1918 and throws no light upon the legislative intent in respect to that Act. It was a departure from an otherwise consistent interpretation of the statute which excluded an allowance for obsolescence of good will and it is submitted that this departure was due to an erroneous interpretation of the statute and is incorrect in principle. Such an erroneous interpretation of the statute by the Treasury does not preclude the Government from imposing and collecting the tax on subsequent restoration of the earlier rule. *American-La France Fire Engine Co.* v. *Riordan,* 294 Fed. 567, 572.

Nor should the fact that in this particular case the record shows that on January 31, 1918, it was reasonably apparent that prohibition legislation

would be adopted, alter the construction of a rule of general application. The Revenue Act of 1918 was not enacted until February 24, 1919, and presumably the effect of prohibition legislation was foreseen by Congress. If Congress had then intended to apply obsolescence to property of a different character from that to which the Treasury had theretofore applied the allowance for exhaustion, wear and tear, we believe that Congress would have expressed its intention in a more definite manner. What it did was to "include" in that allowance a reasonable allowance for obsolescence.

It is quite probable that the outlook in 1918 affected the value of the respondent's good will. But such a change in value does not, we submit, come within the statutory phrase. During the taxable year it was not being used up or consumed by the sales which it produced and was not an exhausting or depreciating asset. The fact that the good will in this case might have a limited life does not in itself make it property which is a proper subject of the allowance. The limitation on the life of property is not the cause of exhaustion, wear and tear. It is merely a convenient measure of the period over which the cost of wasting property should be spread in order that such cost may at all times exist either in the property itself or in the restored capital. Good will is not a separate asset used in the business, and in this respect it differs from tangible property and from contracts and leaseholds. It is nothing but a value attached to a going business.

It may well be doubted whether good will should be considered property "used in the trade or business." *Cf. Landsberger* v. *McLaughlin, supra,* p. 78, *Red Wing Malting Co.* v. *Willcuts, supra,* p. 633. But even if this should be conceded, it is submitted that it is not subject to "exhaustion, wear and tear," and was not intended to be within the allowance for "obsolescence."

CONCLUSION

It is therefore respectfully submitted that the decision of the Circuit Court of Appeals is erroneous and should be reversed.

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